Staff Paper

Project	**Insurance contracts**
Topic	**Other comprehensive income**

Introduction

1. This paper provides an overview of the staff's proposals for reducing the accounting mismatches that arise when insurance contract liabilities and the assets that back them are measured on different bases. The proposals would:

   (a) *permit* an insurer to present in other comprehensive income (OCI) the difference between the effect of using a current discount rate to measure the insurance contract liability and the effect of using the original discount rate at inception. This option would be available when using it would eliminate or substantially reduce an accounting mismatch.

   (b) *require* that this option should be applied on a portfolio by portfolio basis.

2. This paper is based on agenda papers 6B and 6C for the IASB meeting on 12 May 2011. The staff has not asked the boards for decisions in those papers.

Accounting mismatches

3. Many commentators were concerned that the proposals in the exposure draft (ED) did not accommodate the fact that both preparers and users consider the effects of changes in the insurance contract liabilities and the related assets at the same time. In particular, they were concerned that the proposals would result in an accounting mismatch when the assets backing the insurance contracts are measured at amortised cost. Similar mismatches would occur when the assets backing the insurance contracts are non-financial assets, especially investment property, measured at depreciated historic cost, or equities measured at fair value through other comprehensive income.

4. If the assets backing the insurance contracts are measured at amortised cost (or depreciated cost), an accounting mismatch arises in equity and in comprehensive income because the carrying amount of the insurance contract liability does not react to changes in market variables (particularly interest rates) in the same way as the carrying amount of the assets. When assets are measured on a cost basis, the accounting mismatch could be eliminated from profit or loss by presenting the mismatched part in OCI. However, the mismatch would not be eliminated from equity or from comprehensive income. We discuss the ways to eliminate this mismatch from profit or loss below.

5. If the assets backing the insurance contracts are equities measured at fair value through OCI, there would be an accounting mismatch in profit or loss because changes in the carrying amount of the insurance contract liability would be presented in profit and loss. There would also be an economic mismatch because the insurance contracts and the equities would not respond in the same way to changes in economic conditions. In general the staff believes that the economic mismatch would have a far greater effect than the accounting mismatch. Equities held at fair value through OCI are particularly relevant to participating contracts, which we discuss in Agenda paper 7. We do not discuss the mismatch for these instruments further in this paper.

Avoiding accounting mismatches

6. The Basis for Conclusions to the ED noted that insurers could avoid accounting mismatches by using the options provided in IFRSs to measure the assets at fair value. However, many commentators disagreed that expecting insurers to use fair value options was an adequate response to this issue, because it precludes insurers from accounting for their assets on a basis the Board considers appropriate for other entities. In the staff's view, the comment letters indicate that respondents:

   (a) believe that the costs of the additional complexity of presenting in OCI at least some components of the change in the insurance contract liability (see paragraph 30(b)) would be outweighed by the benefits from the information that would be provided by doing so. Commentators believe the accounting mismatch in profit or loss would obscure information about an insurer's underlying performance, and believe that eliminating this mismatch would have the benefits of increased transparency and a more faithful representation of the insurer's underlying performance.

   (b) place greater weight on an insurer's ability to account for its financial assets consistently with other financial institutions (on a 'level playing field') than on simplicity. Many commentators believe strongly that insurers should not, in effect, be precluded from using the default measurement basis for financial assets that meet the criteria in IFRS 9 *Financial Instruments* for amortised cost measurement.

7. Furthermore, most commentators placed more weight on an accounting mismatch in profit or loss than on a mismatch in equity. Thus, when assets are measured on a cost basis, many placed importance on eliminating the accounting mismatch from profit or loss, even though an accounting mismatch remains in comprehensive income and in equity. In other words, they suggested the Board should not preclude the use of OCI in these circumstances if the only reason is that a mismatch would remain in comprehensive income and in equity (the reason given in paragraph BC178(a) of the Basis for Conclusions).

8. The Board considered the arguments raised by respondents when it developed the ED. However, the staff believes that the comment letters have provided greater insight into the relative weights that preparers and users assign to the benefits and costs and to the importance of eliminating an accounting mismatch from profit or loss, even while such a mismatch remains in equity.

9. Furthermore, the staff note that for financial assets, IFRS 9 requires as a default the use of amortised cost when specified criteria are met and provides an option to measure those assets at fair value in order to eliminate or reduce an accounting mismatch. In other words, IFRS 9 permits an entity to eliminate or reduce an accounting mismatch by adjusting the measurement of the assets. The staff believe it would be equally appropriate to eliminate or reduce the mismatch by adjusting the presentation of changes in the carrying amount of the liability. Thus, if an insurer measures financial assets at amortised cost applying IFRS 9 and suffers an accounting mismatch as a result, the staff believes it should have the option to eliminate that mismatch:

   (a) by electing to use the existing fair value option for the financial asset; or

   (b) by electing to present in OCI some changes in the measurement of the insurance contract liability.

10. We consider below:

   (a) How to identify the changes in the insurance contract liability that could be presented in OCI (paragraphs 11-14).

   (b) How to apply a locked-in approach to insurance contracts with floating crediting rates (paragraphs 15-25).

   (c) Whether a locked-in rate should be unlocked for onerous contracts (paragraphs 26 and 27).

   (d) How to display duration mismatches in a locked-in approach (paragraphs 28 and 29).

   (e) How to define the circumstances in which an insurer may present the effects of changes in the discount rate in OCI (paragraphs 30-34).

   (f) The unit of account for this approach (paragraphs 35 and 36).

Identifying the changes in the insurance contract liability that could be presented in OCI

11. If the Board were to consider eliminating some or all of the accounting mismatch from profit or loss by presenting some changes in the insurance contract liability in OCI, the next question is how to identify those changes.

12. For financial assets measured at amortised cost, interest using the effective interest rate is recognised in profit or loss. Some believe that this interest income should be presented together with an amount representing the equivalent expense, ie the unwinding of the discount on insurance contract liabilities. One feature of amortised cost in IFRS 9 is that the effective interest rate is set at inception and not adjusted at later dates (except for variable rate instruments). To be consistent, the unwinding of the discount on the insurance contract liability would be based on the discount rate determined at the inception of the contract and would not be adjusted at later dates (unless interest credited to policyholders is variable). In other words, the staff proposes that the amount presented in profit or loss is determined using a locked-in discount rate, with the effects of the difference between the current discount rate and the locked-in rate presented in OCI.[1]

13. This would permit insurers to depict the relationship between gains and losses from insurance liabilities and gains and losses from the assets backing those liabilities, as described in paragraph 73 of ED:

> "The changes in estimates of discount rates and the interest on insurance liabilities shall be presented or disclosed in a way that highlights their relationship with the investment return on the assets backing those liabilities."

[1] We note that in the amortised cost model, if there are changes in the estimated cash flows from a financial asset or liability, the asset or liability is remeasured at a current estimate of the cash flows, discounted at the original effective interest rate. Therefore, to achieve consistency with the amortised cost model, profit or loss would need to reflect current estimates of cash flows

14. We explain in the appendix to this paper that the underlying performance of insurance contracts could be regarded as the amount that results from excluding the effects of changes in financial market variables, in particular discount rates. Accordingly, presenting the difference between the current discount rate and the locked-in rate in OCI would have the additional benefit of presenting in profit or loss the amount considered by some to represent underlying performance from insurance contracts.

Applying a locked in approach to insurance contracts with floating crediting rates

15. For some insurance contracts, some or all of the policyholder benefits vary as interest rates vary. This raises two issues:

    (a) How would an insurer apply the locked-in approach for such contracts?

    (b) How should an insurer account for any guarantees of minimum crediting rates associated with such contracts?

Determining the locked in approach for insurance contracts with floating crediting rates

16. In the staff's view, if an insurer elects to use OCI to present the effect of interest rate changes on the insurance contracts liability, the interest expense recognised in profit or loss should be determined using the amortised cost methodology described in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*, and in particular its application to floating rate financial assets and floating rate financial liabilities.

17. Paragraph AG7 of IAS 39 describes how to apply the amortised cost (effective interest rate) methodology to floating rate financial assets and floating rate financial liabilities: it states that periodic re-estimation of cash flows to reflect movements in market interest alters the effective interest rate for these instruments, with the result that re-estimating the future interest rate payments normally has no significant effect on the carrying amount.

18. Applying similar logic, if an insurer elects to use OCI to present the effect of interest rate changes on an insurance contract liability, the interest accreted on the liability should be the current crediting rate, applied to the account balance on which that interest is credited. Therefore, in the staff's view, there would be no difference between applying a locked-in approach and a current market consistent approach for insurance contracts with floating crediting rates. Therefore, an insurer is not likely to elect to present the effect of discount rate changes on these contracts in OCI.

Guarantees

19. Some participating insurance contracts and other contracts with floating crediting rates provide a guarantee by which an insurer undertakes to credit a policyholder's contract with the higher of two rates. In other words, these contracts contain an embedded guarantee of a minimum crediting rate. Such guarantees limit the policyholder's exposure to interest rate declines, while preserving the policyholder's ability to gain from interest rate rises. (Thus, these guarantees behave economically in a manner similar to an embedded option.)

20. Paragraph BC44 of the Basis for Conclusions on the ED states that the IASB believes that the measurement model proposed in the ED (ie, the building block approach) would produce relevant information for users of an insurer's financial statements because, amongst other things, it provides consistent treatment of both the time value and intrinsic value of guarantees embedded in insurance contracts[2].

[2] The time value of such a 'higher of' guarantee is the value arising from the possibility that the guarantee may be in the money at the time when it has an effect. The intrinsic value of such an item reflects the extent to which the guarantee is in the money at the measurement date, and reflects the difference between the current level of the variable underlying the option or guarantee and the level specified in the underlying option or guarantee.

21. When an insurer uses the building block model to measure a contract, it considers the expected present value. In principle, the expected present value considers all scenarios, including all scenarios in which the option or guarantee comes into the money. Thus, the building block model captures the time value of embedded guarantees, and not merely their intrinsic value.

22. If an insurer elects to use OCI to present the effect of interest rate changes on the insurance contracts liability, how should it report changes in the time value and intrinsic value of embedded guarantees of minimum interest rates? Arguments for reporting their effect in profit or loss:

    (a) The boards believe that an ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts. Arguably, reporting the effect of changes in the values in profit or loss is the most understandable and transparent way to report them.

    (b) Reporting their effect in profit or loss is consistent with the treatment of all free-standing derivatives and many embedded derivatives.

23. Arguments for reporting their effect in OCI:

    (a) It would be inconsistent to require insurers to report in profit or loss one source of volatility arising from changes in interest rates (embedded guarantees of minimum interest rates) if they are permitted to use OCI to report other sources of volatility arising from changes in discount rate.

    (b) IAS 39 does not require an entity to account for an embedded interest rate guarantee at fair value through profit or loss if it was out of the money at inception. It would be inconsistent with this exemption to require an insurer to recognise in profit or loss (as opposed to OCI) changes in the time value and intrinsic value of minimum interest rate guarantees embedded in insurance contracts if those guarantees were out of the money at inception.

24. The staff make three other observations about insurance contracts with floating crediting rates:

    (a) Depending on the conclusions the boards ultimately reach on unbundling, some contracts with floating crediting rates may need to be unbundled (eg unbundling might be required if such a contract provides an explicit account balance). This paper does not discuss unbundling further.

    (b) We expect that insurers would rarely issue contracts with minimum interest rate guarantees that are in the money at inception. Therefore, if the board does not require an insurer to account through profit or loss for minimum interest rate guarantees embedded in insurance contracts that are out of the money at inception, insurers would reflect the intrinsic value or time value of most minimum interest rate guarantees through other comprehensive income.

    (c) Interest rate changes are not likely to have a significant effect on the carrying amount of these contracts. Therefore, an insurer is not likely to elect to present the effect of discount rate changes on these contracts in OCI, unless the contracts form part of a broader portfolio for which changes in carrying amount are more significant.

25. The staff proposes that an insurer be permitted to present in OCI (rather than profit or loss) changes in the time value and intrinsic value of embedded interest rate guarantees that are out of the money at inception.

Whether a locked-in rate should be unlocked for onerous contracts

26. The staff proposes that there should be no adjustments to the discount rate for interest rate movements after inception, either positive or negative. This would be consistent with the amortised cost model, in which the discount rate is fixed on the day of inception, with no adjustment made for subsequent interest rate movements, positive or negative. Accordingly, there would be consistent treatment of interest rate movements for insurance contract liabilities and backing insurance contract assets.

27. Some suggest that an insurer should unlock the discount rate used to determine the interest expense in profit or loss if it appears unlikely that the assets backing the insurance contract will provide returns sufficient to 'support' the liability. For the following reasons, the staff does not support such an approach:

    (a) the amortised cost regime for financial liabilities in IFRS 9 does not currently include an onerous contract test. Consequently, the introduction of such a test would create an inconsistency with IFRS 9, thus reducing comparability.

    (b) introducing such a test would make it necessary to determine when the test would be triggered, the level of aggregation for the test and whether subsequent changes in interest rates would result in reversals of amounts accounted for in profit and loss.

How to display duration mismatches in a locked-in approach

28. One of the project axioms adopted by the boards is that an ideal measurement model would report all economic mismatches (including duration mismatches) that exist. If an insurer carries its assets at fair value through profit or loss and measures its insurance contract liabilities using the building block approach, duration mismatches will cause effects in profit or loss when interest rates change.

29. However, if an insurer carries assets at amortised cost and elects to use OCI to present the effect of changes in discount rates on its insurance contract liabilities, the effect of duration mismatches will not be visible. To make the duration mismatch more visible in such cases, the staff proposes that when an insurer carries assets backing insurance contracts at amortised cost, the insurer should be required to disclose, in tabular format:

    (a) the carrying amount of those insurance contract liabilities.

    (b) both the carrying amount and fair value of the assets backing those insurance contract liabilities.

(c) the amounts included as a result of changes in interest rates, for both those insurance contract liabilities and the assets backing them, in (i) profit or loss and (ii) OCI.

How to define the circumstances in which an insurer may present the effects of changes in the discount rate in OCI

30. If the Board were to decide that changes in the insurance liability arising from changes in the discount rate should be presented in OCI, the Board would also need to decide:

    (a) whether to *permit* or *require* this treatment in circumstances in which there is an accounting mismatch; and

    (b) whether to *restrict* this treatment to circumstances in which there is an accounting mismatch.

Permit or require

31. In the staff's view, the Board should not require insurers to present in OCI some changes in the insurance contract liability for the following reasons:

    (a) an option to present changes in the insurance liability arising from changes in the discount rate would not show in profit or loss duration mismatches and the value of guarantees. Arguably, using OCI could result in less transparent and less understandable information in some circumstances.

    (b) use of OCI might eliminate part of the accounting mismatch but would add complexity to the resulting information, would be difficult to understand and would be onerous for insurers to apply. This is because the insurer would need:

        (i) To determine the part of the insurance liability deemed to be backed by such assets. Insurance contracts may not be fully backed by assets that are not measured at fair value through profit or loss.

(ii) To track 'cost' information for that part of the liability, to achieve the desired split between amounts recognised in profit or loss and amounts recognised in OCI.

(iii) To determine whether and when to recycle amounts from OCI to profit or loss.

(c) the insurer would still have the option to eliminate the mismatch using the fair value option for its assets.

32. The staff expects that an option to present in OCI some changes in the liability would in practice be used mostly in portfolios where all or most of the assets are measured at amortised cost, and that in turn would be restricted by the criteria in IFRS 9 for determining when financial assets should be measured at amortised cost.

Permit only when used to eliminate or reduce an accounting mismatch

33. In IFRS 9, the option to designate a financial asset at fair value through profit or loss is restricted to circumstances in which "doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different basis." That option was carried over to IFRS 9 from IAS 39.

34. The staff proposes to use the same criteria in IFRS 9 for reducing accounting mismatches using the fair value option for reducing accounting mismatches using OCI in the insurance contracts standard. Accordingly the staff proposes that the Board restricts the option to present in OCI changes in the insurance contract liability arising from changes in the discount rate to cases where doing so eliminates or significantly reduces an accounting mismatch.

Unit of account

35. One of the project assumptions is that, in general, the final standard will measure insurance contracts at the portfolio level. Accordingly, the staff proposes that the assessment of whether an accounting mismatch is reduced or eliminated should take place at the portfolio level, and that the option to present changes in the insurance contract liability arising from changes in the discount rate should be made on a portfolio by portfolio basis. In the staff's view, insurers are likely to consider different factors in matching assets to insurance contract liabilities for different portfolios and therefore, if the option were to be applied at entity level, there might be an increase in mismatches for some portfolios.

36. The staff intends to consider the unit of account more holistically in a future meeting.

Discussion questions
1. Should an insurer be permitted to present in other comprehensive income the difference between the insurance contract liability determined using the current discount rate and the insurance contract liability determined using the original discount rate at inception, if exercising that option would eliminate or substantially reduce an accounting mismatch? 2. Should this option should be applied on a portfolio by portfolio basis? 3. Should an insurer be permitted to present in OCI (rather than profit or loss) changes in the time value and intrinsic value of embedded interest rate guarantees that are out of the money at inception? 4. Do you think that an insurer should lock in the discount rate used to determine the interest expense in profit or loss even if it appears unlikely that the assets backing the insurance contract will provide returns sufficient to 'support' the liability? 5. Do you think that disclosures about duration mismatches would be useful?

Appendix: Identifying underlying performance from insurance contracts

A1. Many respondents to the ED thought that changes in the insurance contract liability should be disaggregated to separate information in the change in the insurance contract liability that insurers see as relating to underlying performance from the change that relates to external factors they see as outside their control. This appendix discusses:

(a) how to identify underlying performance from insurance contracts.

(b) how underlying performance from insurance contracts could be presented, even when all changes in the insurance liability are presented in profit and loss.

A2. We observe that many preparers provide non-GAAP measures, in particular of 'operating profit', in an attempt to explain their underlying performance to investors. Operating profit is often described in ways intended to convey that it represents the profit earned from an entity's normal, core business activities and therefore provides information about the underlying performance of the entity.

A3. Therefore, in attempting to determine how an insurer should identify underlying performance, we took as our starting point the operating profit reported in the financial statements and press announcements of some insurers. We believed an assessment of the items that those insurers excluded from operating profit would provide insight into the type of information that insurers and users would consider to represent underlying performance.

A4. We found that operating profit measures usually exclude non-recurring items and contain adjustments to exclude some investment returns and some financial assumption changes. Such adjustments included market-based fluctuations which many believe to obscure trends in the entity's performance. We did not consider any non-insurance related adjustments, because the classification of such items is beyond the scope of this project.

A5. The adjustments made are consistent with our view, based on the reading of the comment letters and other outreach, that insurers wish to exclude from their operating results the volatility that arises through short-term changes in financial market variables. Those variables relate predominantly to changes in the discount rate and changes in the fair value of financial assets held to back the insurance liabilities. We also note that it may be difficult to distinguish changes arising in financial and non-financial market variables, particularly in contracts for which those changes are inter-related, such as contracts with guaranteed minimum death benefits (eg contracts that pay on death the higher of a fixed sum and the value of an underlying pool of investments). Some insurers reduce this problem by excluding from underlying performance only the effect of changes in discount rate, and not other financial market variables.

A6. We noted that income and expense arising from non-financial assumptions (and changes in them), such as assumptions about mortality and morbidity, are generally included within operating profit. We think that this reflects that such changes are regarded as part of an insurer's operations, are affected by management decisions and, to an extent, manageable, for instance through pricing.

A7. We also believe that the reason for the focus on operating profit is because users see this information as providing a basis for predicting future performance. Many believe that users of financial statements would want to distinguish information that helps to assess the future timing and amount of cash flows from information that helps assess the variability of those cash flows. We note that this view is consistent with the IASB's forthcoming amendments to IAS 19 *Employee Benefits*. In those amendments, the IASB concluded that it is useful to present separately components of changes in a liability when those components have different predictive implications.

A8. We draw from this analysis two points:

(a) Insurers have a desire to adjust profit or loss to report some kind of "underlying" result which provides information about the amount and timing of future cash flows.

(b) Those underlying results typically exclude the effects of changes in financial market variables, in particular discount rates. While such effects provide information about the uncertainty and risk of future cash flows, they provide less information about the amount and timing of those cash flows.

A9. Accordingly, we believe that reporting the effect of changes in financial market variables on both assets and liabilities would provide information that distinguishes changes with different predictive value.

A10. One way to do this is illustrated in the following example:

	'000m
Underwriting margin	14
Gains and losses at initial recognition	3
Experience adjustments	12
	29
Investment income, excluding changes from financial market variables in assets backing insurance contracts	12
Changes in estimates of insurance contract liabilities, excluding changes in discount rate	25
Interest on insurance liability	(23)
Net interest and investment	14
Profit before tax and changes in financial market variables	**43**
Assets backing insurance contracts	17
Changes in insurance liability from discount rate	(15)
Short-term fluctuations in financial market variables	2
Profit before tax	**45**

A11. This example illustrates how insurers might identify separately changes in financial market variables below an operating line (which need not be defined in this project). We believe that similar presentation could be useful in the following circumstances:

(c) To highlight underlying performance when the assets backing insurance contracts are measured at fair value through profit or loss

(d) To reduce the effects of the accounting mismatch when the assets backing insurance contracts are measured at amortised cost, but the insurer does not choose to use the option (proposed in agenda paper 6B) to use OCI.

A12. We have identified no obstacles to providing this presentation, but do not believe it should be required.